

Jan. 10, 1990

LETTER 1034

THE PICTURE: Back in 1938 Robert Rhea, the great Dow Theorist of the 1930s, wrote the following:

The movements of BOTH the Railroad (now the Transportation) and Industrial stock averages must always be considered jointly. The action of one average must be confirmed by the other before reliable inferences may be drawn. Conclusions based upon the movement of one indicator, unconfirmed by the other, are almost certain to prove misleading.

Can the rules and observations of a half century ago be applied to our go-go, electronic, program-trading markets of today? I personally feel that the confirmation principle is still entirely valid. At any rate, we certainly have an outstanding example of a nonconfirmation in today's market. On January 2 the D-J Industrial Average surged 56.95 points to a new all-time high of 2810.15. On the same day the D-J Transportation Average vaulted 23.29 points - yet at the close the Transports were still more than 300 points below their September 5 peak of 1532.01. Any way you look at it, that was an historic nonconfirmation. The lag in the Transportation Average was and still is dramatic.

But wait. Can the market action of a few months ago (be it good or poor) set the tone for today's market? Just because the Transports did poorly during the September-December period, does that mean that the market's action should be doubted today? That's a question that has been dogging technical analysis since it was first introduced around the turn of the century. And my answer is yes -- what the market did in the past often sets the pattern for what it will do today and tomorrow. But there is another observation (never to be forgotten), and it is that "the market can do anything." In other words, the stock market has definite tendencies, but no rule or formula regarding the stock market will ever be infallible.

To return to today's situation, no question about it, there are a lot of technical discrepancies in this market. The nonconfirmation on the part of the Transportation Average is glaring and obvious. Other discrepancies -- the NASDAQ (over-the-counter) Index has been a terrible laggard, recently breaking down below its October 13 mini-crash low. The AMEX Average has also been a definite laggard as has been the broad Value Line Index.

There's more -- the advance-decline ratio for the NYSE (a proxy for ALL NYSE issues) has acted poorly, and is currently well below its September peak (see page 2 chart).

Daily new lows on all the exchanges have been excessive over the past few months, and Joe Granville, in his most recent mailing, reports that over 600 NYSE issues are currently within one point or less of their 52-week lows.

What about my own "fail-safe" indicator, the **Primary Trend Index (PTI)**? Here the action is impressive. Last week the PTI climbed into record high territory. Thus the relentless, bullish trend of the PTI remains intact. I've written this many times before, but I might as well repeat it for new subscribers: You don't have to believe what the PTI is saying. If you're worried about the market, cut down on your stock holdings or even move to cash (after all, there are plenty of technical problems in this market to worry about). But don't ever position yourself against the PTI (and I'm talking about shorting stocks when the PTI is in the bullish mode as it is now). When you do that you're fighting the PTI, and 18

Dec. 29 DJIA 2752.99; PTI 3313; A-D Ratio -7.29
Jan. 5 DJIA 2773.25; PTI 3309; A-D Ratio -7.12
Dow Yield: 3.84%; Dow P/E: 11.9; DowPow: 702
Dow Book Value: 1075; Dow 200-day MA: 2582
Percentage of Undervalued Blue-chips: 17%
PTI 89-day Moving Average: 3266

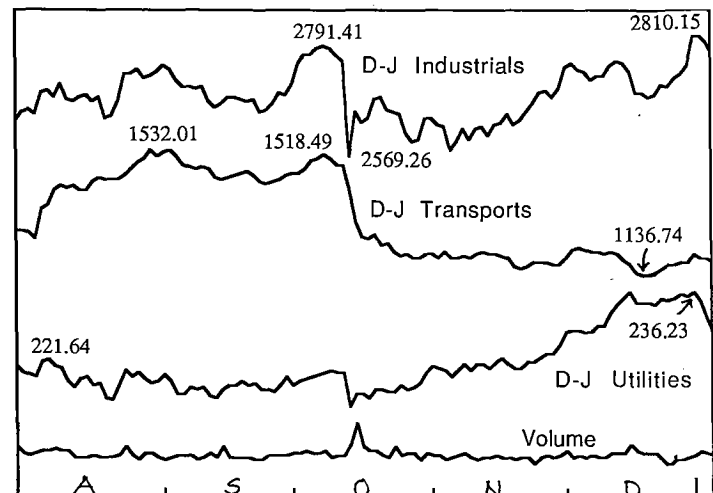
years of experience with the PTI has taught me that going directly against what this index is saying can really thin out your wallet.

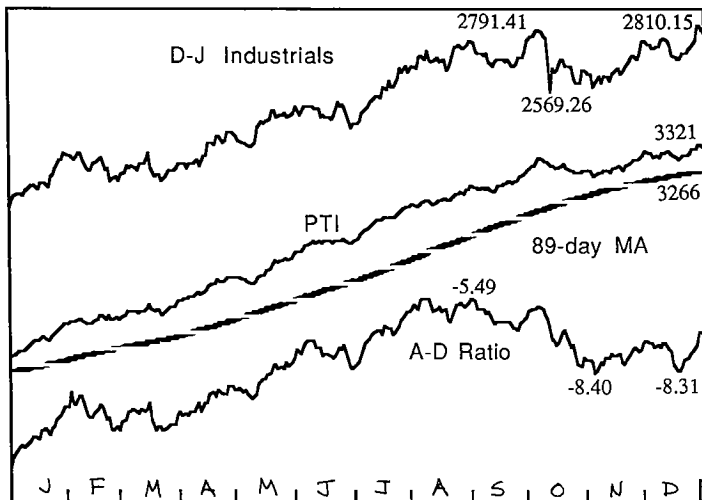
From a fundamental standpoint, what could the Wall Street bulls be looking at today? My guess is that, rightly or wrongly, the market has been preparing itself for the opening up of Russia and Eastern Europe -- an opening that would be particularly beneficial for American consumer goods. The ultimate "flowering" of Russia and the East would entail opportunities for big US corporations with outstanding export capabilities. Many of the stocks in the Dow fit this description, and, of course, it is the Dow which has been the outstanding performer since last October.

Another bull argument is that there will be low growth (with low inflation) but no recession in 1990 and for the foreseeable future. Maybe. Only a crystal ball-er could say that this view is definitely wrong. However, the low growth, low inflation, low interest rates thesis is the overwhelming consensus view, and such views should always be taken with a bit of skepticism.

Note on reading the Averages: A secondary peak was established by the D-J Transportation Average on December 5 at 1220.84. So far, even with the early January explosion, the Transports have not been able to climb above that December 5 peak. The ability (or failure) of the Transports to better the 1220.84 peak may tell us quite a bit about the market's strength or lack thereof.

Interesting Comment: The latest (January 1990) issue of the authoritative *Bank Credit Analyst* begins as follows: "The makings of a financial crisis are in place. A massive rise in debt levels in the US in a generally disinflationary environment has created vulnerability which has been disguised to some extent by the apparent timeliness of the Fed's move last spring to reduce short-term interest rates. This has bred complacency because previous post-war money crunches have been triggered by spiraling nominal interest rates."





Further comments: Do you wonder (with a goodly portion of US industry rather sickly) why the Fed doesn't lower the bank discount rate? The answer: Japan and Germany haven't given Greenspan the go-ahead. The fact is that our creditors are afraid of US inflation, and they're particularly fearful of a big slide in the US bond market. Therefore, the word from our overseas creditors is, "Sit tight -- hold the line, we don't want runaway US inflation, we don't want another crash in the dollar, and we certainly don't want a slumping US bond market." Remember, during 1985-87 the Japanese and other US creditors took a fearful beating when the dollar dropped almost 50%. Count on it, they will not be willing to take that kind of beating again.

On December 25 the Bank of Japan raised its key bank rate a half percent to 4.75%. That was the third such increase this year. The raise was calculated to contain rising Japanese inflation and to make the yen more attractive against the dollar (or to make the dollar a cheaper currency). The word is that Japan would like to bring the dollar down to around 130 yen per dollar (as against around 145 yen to the dollar today).

Why? The answer is that Japan is worried about the continuing US trade deficits. And they're worried about the sloppy US economy. A cheaper dollar (cheaper but not too cheap) would help US exports in that it would make US goods cheaper for foreign buyers.

You see, Japan has a dilemma of its own. On the one hand Japan wants to dominate (surpass) the US and become the world's leading economy. On the other hand, Japan doesn't want to see a collapsing US market (Japan has too big an investment in the US). Japan's solution: Try to keep the US ship on a steady course for as long as possible -- meanwhile beating the US on every turn in manufacturing and production of goods and services.

As to the future, if the US becomes a bankrupt shell of a nation there are always the potentially huge markets of China and Russia and hopefully Europe. In the meantime, build up the wealth, savings, and productive capabilities of Japan. And try not to ruffle the US's feathers, at least for now.

From everything I read and study, I believe that Japan views the US as a declining power, a nation battered by debts and deficits, a nation living on delusions of self-importance, a nation wracked by inflation, crime, dope, AIDS, and beset by almost unsolvable minority and racial problems.

On the other hand, the Japanese see themselves as a (racially) homogeneous nation, a nation that is growing ever wealthier, more efficient, and more powerful. Japan sees itself as the economic wave of the future. And the future is a relentless Japanese economic machine. Thus, via economics the Japanese will attempt

to do what they were unable to do during the 1930s and 1940s and during World War II. This time Japan sees itself as the leading economic power in the new world of the 1990s and beyond. Can it happen? Will it happen? So far, the answer seems to be "Yes."

INVESTMENT POSITION:

The divergences plus the weak breadth on all the exchanges have bothered me -- a lot. Consequently, I've moved mostly to cash and gold items. My wife, Faye, has very much her own mind, and she handles her own money. She has elected to stick with the PTI. Therefore, she's staying put with her no-load stock funds. When the PTI breaks its 89-day moving average, she says, "I'm out of stocks. Until then, I sit."



Which stance is the correct one? The only answer I can offer is that my stance is correct for me, and Faye's stance is right for her. We both sleep pretty tight at night, and to me that's crucial.

A lot of bearish analysts are recommending shorts now. I wouldn't dare put out shorts while my PTI is still rising. Most analysts are recommending selected stocks to buy for the 1990s. There's too much divergence in this market for me to go that route. I'm not greedy, but I am patient. That means (for me) sitting tight.

MONEY AND THOUGHTS: Long time subscriber John Train wrote "The Money Masters," one of the most widely read investment books ever written. Now John has come out with a follow-up, "The New Money Masters" (Harper & Row, \$22.50). The book is about eight spectacular money investors and managers, some well-known like Peter Lynch and George Soros, other less public such as Ralph Wanger and Philip Carret. They all have a few things in common -- original, unique, and often weird minds, access to mounds of information, and huge sums of money which they employ.

The book is fascinating, and the various methods and techniques which these men use are outlined and studied. But take heed -- the advice from these eight investment masters is often conflicting or else it requires a lot more talent than the average investor can muster.

At the end of the book, Train seems to scratch his head while offering some very sound philosophy. Writes Train, "Understand the process, the way you should understand medicine and government, but don't try too hard yourself. The people who sustain the worst losses are usually the ones who overreach. And it's not necessary; steady, moderate gains will get you where you want to go . . . And great wealth spoils ordinary human contacts. Everybody wants something. Of the Rothschilds it was said that they had no friends, only clients. . . . The rational approach is to trust in a sufficiency of wealth as a by-product of a useful life. Happy are those who find fulfillment in their families, their work and their civic duties, and hope for the best."

Wise words, and words I agree with. I have had friends who were "blessed" with great wealth. Some made it themselves, others inherited it. Some increased it, some lost a good part of it, but I can't swear that having the wealth made them any happier. In most cases, it did make life easier for them, but an easy life is not necessarily a happy one. One of my best friends, heir to a very large amount of money, was particularly bright and gifted. But I always thought the money he inherited was his worst enemy. He did very little with his life, about 10% of what I thought he could have done.

As for those who make their own fortunes, in general they probably fare better than the heirs. But I know a number of these ambitious people too, and I would have to say that their families are probably less happy than the families of those who are only

moderately successful (successful from a monetary standpoint). Remember, very few people make a fortune working an eight- or even a ten-hour day. Fortunes are usually made by workaholics or those who are obsessed.

And speaking about money, earned or inherited, what about our kids? How much should we leave them (assuming we are in a position to leave them anything)? I have long pondered this question, and I have never come up with a satisfactory answer. I guess a lot depends on the psyches of the kids themselves, but who knows how inherited money will affect another human being?

A blushing confession: I spent my early years going through private grammar school and private prep school. Both schools had many kids from very wealthy families. Although my own father always provided us with a good life, I grew up feeling that what we had was not enough (meaning, we didn't have as much as the richest kids in the class). My father was a wise man, but he was also a very conservative man, and he didn't like to take chances. He once told me, "Richard, if you want to make money, get in your own business, get in a business that sells the world, get in a business that is not dependent on one geographical location, and above all, if you want to make money you must go where the money is." So I asked my father, "Where is the money?" And he answered, "One place it is in the money business -- banking, Wall Street, the markets."

So I ended up being fascinated with Wall Street and the stock market. I love the markets, and I never regretted my choice of profession. But I also agree with John Train's advice. I believe in moderation, in compounding, and in trusting to sufficiency. Through a life-long plan (which very definitely includes compounding, as veteran subscribers know) I now have all the money I need -- maybe not all I ever wanted, but all I need.

The other day I asked my wife, Faye, "Do you think our life would be different if we had \$75 or \$100 million?" She answered, "Probably, but look what you might have had to do to make it. I don't think you're the type -- it's not in your makeup. I don't think you would be willing to make the sacrifices necessary to make that kind of money." Yeah, I had to agree.

As for my kids (ages 9 to 34), I give them annually the maximum that the estate tax law allows. I don't know if I'm doing the right thing. I feel that children are influenced to a large extent by their parents' values and their parents' attitudes towards life. So far, I've been very lucky, as I think all my offspring are good kids. But I'm not kidding myself. I'm still somewhat influenced by that childhood feeling that my family "didn't have enough." I didn't want my kids to have that same feeling. And I guess that's the real reason why I give them what I do. I hope I'm doing right. Time will tell. In the end, they'll have to struggle with life on their own terms. If I've made their life easier, I guess that's all right. And if I've made them little princes and princesses, I'm sorry, I did the best I could.

NOTES & QUOTES: I've been doing a lot of thinking about the US and Japanese markets. The Japanese Nikkei has now soared into the mid-38,000 level while the Dow is still around 2700. Both Averages started at roughly the same level back in 1949, three years after World War II ended.

Suppose both of these stock averages were individual stocks. Technically, wouldn't it simply be a case of far superior relative strength on the part of the Nikkei? Wouldn't you say that one stock was a winner and the other was being left far behind?

One of the basic precepts of technical analysis is that the market tells all -- that everything anyone knows about stocks, earnings, and values is factored and distilled down to the action and level of the averages. If so, aren't comparisons between the Dow and Nikkei telling us something?

Here's what those comparisons are telling me. Japan Inc. is leaving us in the dust. Every time I pick up the newspapers or magazines I

read about another industry in which the Japanese are beating us. The latest is space age materials, a great growth area in which the Japanese are now taking the lead.

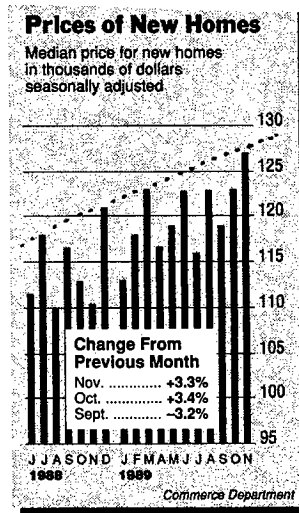
Another thought: relative strength usually remains in force regardless of whether the general market is in an advancing or declining phase. If so, and if a global bear market enters the picture, shouldn't we expect the Japanese market to do better (percentage-wise) than the US market? Despite what people say about the lofty current height of the Japanese market, I would expect the Nikkei to outperform the Dow during any world bear market.

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Does anyone really believe that inflation is running at a rate of only 4.5% in the US? My guess, based on what I see and what I have to pay, is that inflation is nearer 8-10%. And I'm talking about the things we really buy, such as food, movie tickets, clothes, tickets to Disneyland, insurance, cars, medical, etc. The sagging bond market seems to sense what's really happening vs. what our Government tells us is happening. I suspect that Fed head Greenspan senses it too.

By the way, homes sales may be sluggish, but study this chart. Prices of homes are still rising. No inflation? I think inflation is still a big threat. And so do the Europeans.



Currency traders were shocked on January 5 when the dollar took a huge dive. What happened was the Japanese, German and Swiss banks all sold dollars in large amounts. The West German attack on the dollar came as a particular surprise (it was the first time the Bundesbank had intervened since last October, and the attack came with the dollar relatively low against the mark). What was the Bundesbank saying? The Bundesbank (known as the "Lone Ranger" of the G-7) was saying (1) that it wanted a strong mark, (2) that it liked what happened in late-1989 (when the mark surged against the dollar), (3) that it wanted to reign in inflation in Germany, and (4) that it wanted to keep the mark as the "powerhouse" currency of Europe.

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The nasty tax "sleeper" is the level (and the steadily rising level) of state taxes. *Money* magazine (January) provides a most revealing run-down of what it costs you in taxes to live in the various states. The best states (taking into account all state taxes from death taxes to sales taxes to state income taxes) are as follows: (1) best is New Hampshire, (2) Florida, (3) Alaska, (4) Texas, (5) Nevada, (6) Washington, (7) Connecticut, (8) Wyoming, (9) S. Dakota, (10) Tennessee.

Here are the worst or highest tax states: (1) worst is Hawaii, (2) Oregon, (3) D.C., (4) Maryland, (5) Idaho, (6) Utah, (7) New York, (8) Wisconsin, (9) Minnesota, (10) Maine. Interestingly, California is about in the middle range at 25. Some cities have extra taxes. New York City, for instance, adds a killer tax of 3.4% on all income over \$108,000. Detroiters pay an extra 3% tax on taxable income. In Pennsylvania you pay 2.1% on a broad base of taxable income, and in Philadelphia you pay a flat 4.96% on taxable income.

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Speaking of states, all six New England states are now having financial troubles, and the question is -- will they raise taxes? Six other states are being squeezed and could be in line for tax boosts -- they are Arizona, Alabama, Florida, Kentucky, New Jersey, W. Virginia. States rolling in bucks are Arkansas, Idaho, Iowa, Washington. New York is considering rescinding a scheduled income-tax cut. Note: Fastest growing state in the Union is now Nevada. Nevada, by the way, has no state income tax.

Bobby Beathard is the new general manger of the San Diego Chargers. So watch the Chargers' star rise in the West. Beathard is so knowledgeable about football that I've never missed a chance to hear him talk. I'll admit it -- nothing fascinates me as much as a person who is truly expert in his field, and I don't care what that field is -- archeology, criminology, making bagels or football.

Vice President Dan Quayle's family sent out 30,000 Christmas cards reading as follows: "May our nation continue to be a beakon of hope to the world." The Quayles sure won't be a beacon for spelling. Yeah, they spelled it "beakon." The cards were paid for by the Republican National Committee.

Papua New Guinea (100 miles north of Australia) is the last unexplored area of the globe. PNG has an area twice as large as Great Britain but has a population of only 3.5 million. Riddled by mountains, rivers, and rain forests, PNG has many tribes that have never seen each other. It also has 700 distinct languages, or half the known languages in the entire world!

In 1990, for the first time since the US became a world power, foreigners will own more of US businesses than we will own of their's. Items: Britain owns \$101 billion in US assets while we own only \$48 billion in Britain. Japan owns \$53.3 billion in US assets, we own \$16.9 billion in Japan. Holland owns \$49 billion in the US, we own \$15.4 in Holland. Milestone: For the first time a foreign car is the No.1 seller in the US. The car -- Honda's Accord.

I've always been fascinated by the techniques of successful speakers. Forgetting what they say, it's the way they say it, the way they control the crowd that interests me. Hitler absolutely hypnotized the German people with his feminine gestures and screaming hysterics. Jim Bakker captured his audience with his little boy, sugary "sincerity." Roosevelt did it with his aristocratic accent and his forcefulness. Churchill did it with his fantastic command of the English language and his powerful poetic speech. Jimmy Swaggart did it with sheer dramatics -- crying, beating his chest, dropping to his knees, whining, threatening. Last week I listened for two hours (C-Span channel) to Louis Farrakhan, the black minister of the Nation of Islam. A tremendous speaker, first whispering, then shouting, smiling then glowering, laughing then snarling. Adding to the drama was the ring of guards surrounding Farrakhan. What an actor he is. His ominous message was something else. I won't even go into that.

Boy, did I get a fabulous Christmas present from my wife, Faye. It's the new 20-volume Oxford English Dictionary, which *Newsweek* termed, "In all probability, the greatest continuing work of scholarship that this century has produced." The *Times* called it "One of the greatest books published since the invention of printing." If there was ever a word uttered in the English language, this massive dictionary has it -- with its origin, its use, and its meaning. Who uses the Oxford? Anyone who's ever had a love affair with words (that's me).

Auto companies are now offering an astounding total of 578 car models to choose from. The Japanese, with 22% of the US car market, are shooting for 40-45% by the mid-1990s. Even now, with US factories shutting down and with US dealers choking on unsold inventories of cars, the Japanese are surging ahead, pouring hundreds of millions of dollars into new factories, products, and dealerships. For the first time Japanese firms (Toyota) are opening up dealerships in the Midwest. Toyota has surpassed GM as the world's largest manufacturer of cars. The GAO states that Japanese transplant factories can build 200,000 cars using 2,666 workers vs. 4,236 workers building the same number of cars at US-owned plants. Says Chrysler's Iacocca, "The transplants are murdering all of us, all of the Big Three." Says a top US dealer, "For half a million dollars a guy's got a Toyota franchise. He'll get his money back in a year. There are a lot of domestic dealers in the Midwest who are dying to get those franchises because they're not selling Oldsmobiles as they used to. That's the Japanese threat defined."

Whatever happened to canaries? When I was a kid every third house had a "chopper" or a "roller" (the two types of singers). Now the "in" birds are parrots. Parrots are amusing, beautiful, messy, and expensive. But I miss those beautiful singing canaries. Speaking of animals, within half a mile of my house (a mile from downtown La Jolla) you can find foxes, possums, squirrels, skunks, raccoons, and coyotes. When I put food out for our cat, it is invariably eaten by possums. Ah, the call of the wild.

In the drug world, the coming scourge is the "designer drug." These are the lab-produced drugs that do not have to be imported. The nightmare of the future, say experts, are drugs such as LSD, PCP, MDA, barbituates, amphetamines, and China White, a more potent and cheaper form of pure Southeast Asian heroin. Every organic drug has a synthetic counterpart that is cheaper, stronger, and more varied than the original. States Gene Haislip, the D.E.A.'s designer drug expert, these synthetic drugs are a "pharmaceutical Frankenstein." The only reason they are not more widely used is a lack of organized distribution. But that's changing too.

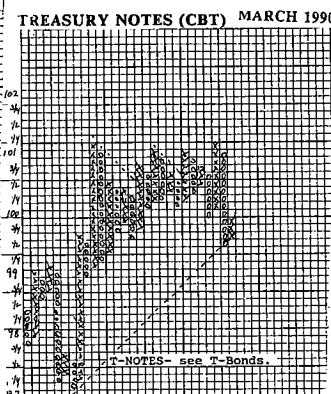
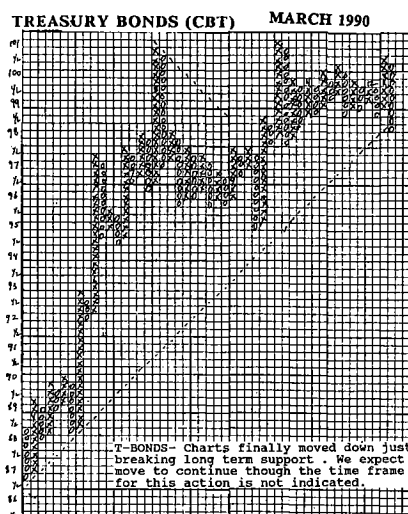
Singapore and Malaysia have their own way of dealing with drugs. If you are caught with over a specified amount of a given drug (7.05 ounces of marijuana or hashish, 2.2 pounds of opium, 1.41 ounces of cocaine), you are considered a dealer. The penalty -- death by hanging. Says Poh Geok Ek, director of Singapore Narcotics Bureau, "Punishment must be strict or otherwise the penalty has no meaning. We hang anyone convicted who exhausts their appeals. We also hang old ladies, even if we don't normally publicize it. I you get caught, you face the music."

CHARTS: I've received sell signals on most of the money instruments: T-bonds, T-notes and T-bills. How far down will these instruments go? There's obviously no way of knowing. These point & figure charts (courtesy *Chartcraft*, PO Box 2046, New Rochelle, NY 10801) tell the story, and the story is one of initial breakdowns.

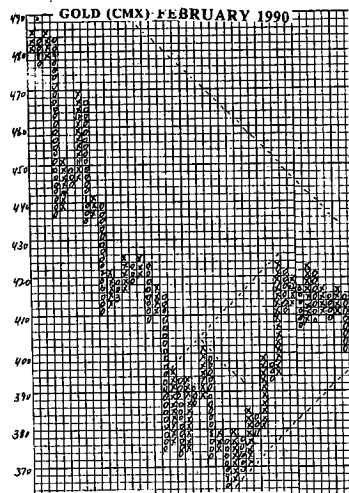
What's happening? (1) Interest rates overseas are rising (due to inflation there), and that's putting competitive pressure on US interest rates. (2) The almost unanimous opinion that interest rates are fated to decline in the US -- that opinion seems almost doomed to be wrong. (3) The Fed itself may be worried about inflation. Personally, I continue to see signs of rising prices in the US, both in wages and in the price of goods.

Crude oil has been going through the roof (see chart), and with both gold and oil in rising trends, this constitutes an inflationary "red flag." This chart of the March crude oil contract tells the story.

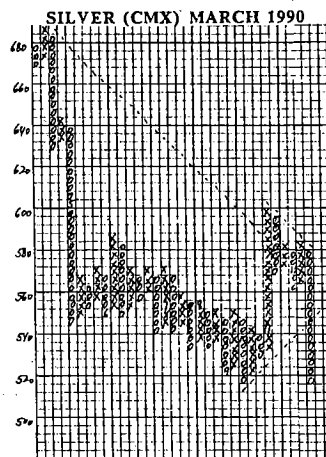
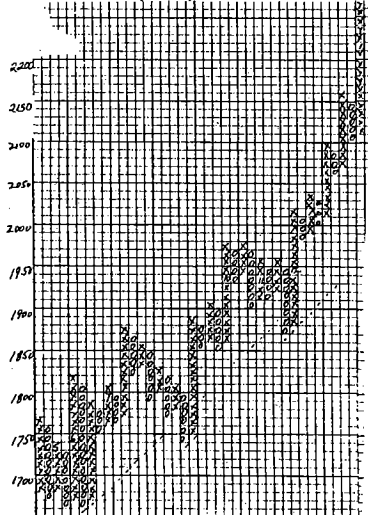
The Feb. gold contract has now traced out a rising channel, and it wouldn't surprise me to see gold hold within this channel. Rather disconcerting to most precious metal bulls, the action of silver (which ordinarily moves in harmony with gold) has been poor.



This chart of the March silver contract looks bearish. What's the story here? My only answer is that (1) too many people said that silver was the metal to buy, that silver was cheap compared with gold (and on an historical basis that's true). (2) Gold is the monetary metal, and silver is not -- no central bank in the world is interested in silver. (3) They never make it easy. The markets always give you something to worry about. The silver/gold divergence is the market's gift to the worriers.



CRUDE OIL (NYM) MARCH 1990



SILVER- Also weaker than gold with sells shown and charts down at low levels seen last October.

COMPOUNDING DEBTS and GOLD: I've written many times over that the "royal road to riches" is compounding. Save \$10,000 a year at a compound rate of, say, tax-free 6%, and in 20 years you've got a third of a million bucks. But run up bills of \$10,000 a year, and compound those bills over those same 20 years, and you'll be the most bankrupt guy in your neighborhood.

Compounding is the single most powerful force in economics. That's a lesson that may slowly be dawning on the consciousness of Americans. Year in and year out, decade after decade, through good times and bad, the US government has been spending more money than it takes in. They call that process running deficits. Furthermore, the interest costs of those deficits produce interest on the interest on the interest. They call that process compounding, but in this case it's negative compounding.

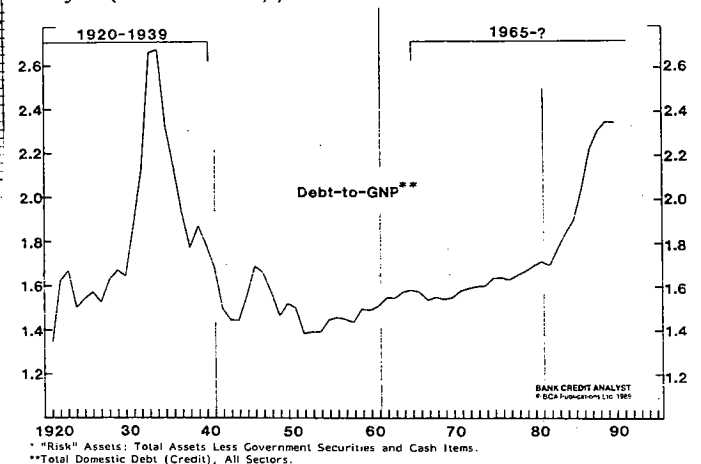
This negative compounding effect, this compounding of continuing deficits, is shaping up as one of the greatest economic problems in American history. Ten or 15 years ago I could have come up with the prescription for avoiding the coming debt catastrophe. The prescription at that time would have been to balance the federal budget or better still, run surpluses and actually lower the federal debt.

But what about now? What can we do today? At this point, I have no brilliant answers. The tragic truth is this -- even if we run zero

deficits and even if we can successfully finance the outstanding federal debt (now almost \$3 trillion), by the year 2001 the compounding effect will give us a total federal debt of over \$7 trillion. But if we continue to run deficits of say \$100 billion a year, then (at interest rates of 8%) by the year 2001 we will have a federal debt of near \$10 trillion. With a \$10 trillion federal debt at an 8% rate of interest, you're talking about annual interest costs of \$800 billion or \$15.3 billion A WEEK. Mmmm.

All right, what if we get frugal and run surpluses? If, at this point, we attempt to run surpluses in order to reduce the federal debt, such action would be almost guaranteed to trigger a depression. Why? Because the US has been living high on the hog via borrowed money. Cut out the borrowing, boost saving and surpluses, and the economy would collapse. Today the US economy is like a car running at high speed around a curve. Slam on the brakes and centrifugal force will send the car off the curve and into space.

The chart on page 2 tells an ominous story. Here we see US debt-to-GNP from 1920 to the present. Currently, this ratio is the highest since the late-1920s. At some point this ratio must top out. When it tops out that will mean that GNP (gross national product) has turned down. Mind you, the debt will remain. It's the GNP alone that will decline. When GNP declines, the debt will act like a noose around the neck of the economy -- and the economy will collapse. Businesses and individuals that are heavily in debt will go bankrupt, prices will cave in, deflation will take over and recession or depression will be the result. (Chart courtesy of Bank Credit Analyst (514-874-1894).)



The ramifications of the process described above are serious. But this is the point I started out with, and this is the point I want to emphasize now. The continual running of US deficits plus the inexorable compounding process is producing a totally out-of-control mountain of federal debt. It's a geometrically exploding situation, a rising parabolic curve of debt.

All of this is slowly seeping into the consciousness of all who hold the US currency -- dollars. As the US and the world's dollar-holders perceive what is happening, as they see the incredible, compounding build-up of federal debt, skepticism about the worth and even the viability of the dollar will grow (see chart on page 6 of the last Letter).

This would be a serious enough situation for any currency, but there are two problems which are unique in the current situation. First, the dollar is the world's RESERVE currency. This means that nations hold dollars in their central banks as reserves. Many of these nations are creditors of the US. What will happen as these nations perceive the wild build-up of US debt? Obviously, what will happen is they will try to get out of dollars -- into other currencies and gold.

The second unique item in the current situation (and this is very important) is that unlike South American nations, the US has huge capital markets. The US has trillions of dollars worth of bonds and mortgages outstanding. As the dollar sinks in value, the Fed will be

forced to hold or even raise rates in order to make the dollar more attractive to our creditors. When this happens, bonds and mortgages will go down in price. Worse, as the situation is fully perceived, the US capital market will collapse.

Next, there will be a rush to move into strong currencies. There will also be a panic to accumulate the only money that has no liabilities against it. And I'm talking about true money -- gold.

Question: Russell, won't the Fed fight this whole process? I can't see the Fed allowing the US to sink into a deep recession.

Answer: Of course the Fed will fight a recession. But how do you fight compounding debt and a sinking currency? On the one hand, the Fed will want to bring interest rates down to fight recession. On the other hand, the Fed will want to raise interest rates to support the dollar. Unfortunately, there is no answer that I can come up with to undo what decades of profligate financing have done. Ultimately, the piper must be paid. And the longer payment is held off, the more painful the results will be when the party ends. The compounding process is now moving into high gear, and that tells us that the end of the US debt-party is drawing closer, much closer. Gold, acting as a barometer, is probably our best indicator of when the real trouble will hit.

Question: What's your guess as to timing of the trouble?

Answer: I hate to guess on this one, but I'd say that we'll have all the trouble we want within the next two or three years. I'm thinking that gold over 500 would probably be as good a major danger signal as any. Gold over 500 would get the world's attention -- you can be sure of that.

Question: What do you think Europe and Japan will do as the dollar and the US debt build-up spirals upwards?

Answer: My guess is that Europe and Japan will put increasing pressure on the US to address its deficits. But our creditors' instincts will also be to save themselves. This will mean a move to get out of dollars. The alternatives will be the hard currencies and gold. However, it will not be easy to get out of dollars. It's not easy to just dump a reserve currency, a currency that makes up the great bulk of your reserves.

So there will be increasing political pressure on the US to be responsible, to balance its budget, to take strong action. There will also be rising anger directed against the US. The US will be (and is being) viewed as a spendthrift, a weakening colossus. The first reaction from our creditors will be derision and criticism. After that, the reaction will be anger directed at the US, the nation that couldn't manage the world's reserve currency.

Question: In view of all the above, what do we, as investors, do?

Answer: Our first job is to survive. How do we do this? As I see it, we do it with gold. Gold is coming into the world monetary system. The Soviets will probably be forced to issue gold-backed bonds. The ruble will, in due time, have to be gold-backed. Japan and the rest of Asia are currently stepping up their buying of gold. As the compounding disaster of the US debts is perceived, I believe the entire world will move toward the safety of gold.

I believe that this is the beginning of a major, long-term bull market in gold. The US and other nations may well try to control the gold bull market, but there is a force behind the gold bull market that cannot be controlled. That force is the force of compounding as it works to increase the US federal debt.

In the end, the gold bull market (like all primary bull markets) will not be amenable to control. It may be temporarily manipulated or held back, but ultimately it will express itself -- in higher prices for gold in terms of deteriorating paper money.

So my answer to the question, "What do we do?" is this. We move into gold items.

Question: Won't the government do all in its power to stabilize or shut off any bull market in gold?

Answer: If you remember, back in the 1970s the government, the Treasury, the Fed, and everyone else tried to hold gold back. Fed Chairman Volcker denounced gold as a "barbaric relic." At that time the government did everything it could to hold down the price of gold, but gold was in a primary bull market, and it moved from the low 40s to 875 in 1980. The government was completely defeated in its efforts to hold gold down (even today, the US government stubbornly and stupidly values its gold at \$44.20 an ounce, thereby refusing to give in to the reality of the marketplace).

Before it's all over, this new gold bull market will fully express itself. Now let me make one thing clear -- I don't know (nor does anyone else) whether gold is fated to rise to 600 or 6,000, nor do I know whether the bull market will last a year or a decade.

As I outlined earlier in this piece, America's federal debts are compounding at a frightening rate. Next year just the interest on the federal debt will be \$187 billion or \$3.9 BILLION A WEEK! That's the fact. There is no manipulating the laws of compounding any more than we can manipulate the law of gravity. Trillions of dollars of debt are continuing to pile up, and these debts will either be paid off via inflation (in dollars that are worth less and less) or the debts will ultimately be reneged on. Of course, the Treasury will also try to refinance the debts and extend them (even now they are talking about 40-year T-bonds). But that process has a limit. The debts cannot be compounded indefinitely, that is a certainty. The totals will just become too great -- and too frightening.

In the world as we know it, there are two sure things -- death and taxes. Add a third -- the power of compounding. This compounding of US debts is the central underlying, long-term force that will fuel the gold bull market. As doubts about the US's ability to pay off its debts increase, as the debts rise to towering proportions, the perception among the US's creditors will be that they are playing a losing game in holding dollar denominated items. That's when the gold bull market will start expressing itself in earnest.

So I am saying that patience will be needed with this gold bull market. I don't know how much patience will be needed, and I don't know exactly how the bull market will develop. But develop it will, and all the authority of the Fed, the Treasury, the President, and Congress will be powerless to stop it. The gold bull market will express itself just as surely as the US debts are continuing to compound -- hour after hour, day after day, month after month.

LATE NOTES: Taxi fares in NYC just went up. Disneyland just upped the price of admission two bucks. The prices of art, autos, baseball cards, and gold are holding high or continuing to rise. New home sales are perking up, and durable goods order are popping again. Last Friday the CRB Commodity Futures Index closed above 232, its highest level since last July. The Fed is now easing, and the bond market (sensing a revival of inflation) has started to sink. With the dollar weak against the major currencies, the problems are just beginning to surface. For instance, West German investors have just lost a year-and-a-half of coupon income due to dollar weakness against the mark (how much longer will the Germans and Japanese continue to buy our debt?). Long-term T-bond rates are now pushing against or above the 8.25% level (say good-bye to 7.75%, the recent low for T-bond rates).

Here's the headline from the January 4 *Christian Science Monitor*. It's the consensus opinion, and opinion being mouthed by almost every economist in the nation. Don't believe it. The bonds are saying that something different is in the wind (I'm not sure what, but it will be something different).

Analysts See Slow Growth, But No Recession in 1990

US companies scramble to keep sales up with new products, rebates